

# Credit application

# HSB NORDBANK

14/12/2007

BU: FMD and Real Estate  
OE: Structured Credit Analysis, London Branch

New

Competence Level 1

## 1. Borrower Data

**Borrower, Bearer of economic Risk (TWR)**

1) A new SPV to be established, with such a name to be agreed between the parties ("NewCoSPV1")

2) A new SPV to be established, with such a name to be agreed between the parties ("NewCoSPV2")

2) A new SPV to be established, with such a name to be agreed between the parties ("NewCoSPV3")

**Borrower Unit, TWR-Group, (if necessary: Internal Risk Unit)**

NewCoSPV1, NewCoSPV2, NewCoSPV3

Relationship since n/a  
Strategy Compliant x  
Opportunistic  
Rating HSB Nordbank LCR 1(AAA)

External Rating n/a

Großkredit

Organkredit

Risk Provision  
(EUR m)

**Industrial Sector**

**Risk Country**

Special Purpose Vehicle ("SPV")

Ireland

### Essential notes

The transactions contemplated reflects HSB's desire for optimisation of its Risk Weighted Assets. Recourse will be limited to the assets held by the SPVs. The KYC process of HSB in co-operation with the Compliance Officer will commence upon receipt of credit approval for this transaction. However the SPVs are SPVs partly sponsored by HSB no problems are immediately foreseen. Given the similarity on the risk profile the facilities for the SPVs are applied for together in this one application.

## 2. Economic equity requirement

as per	Economic Equity (EUR million)			LGD	Comment
	Existing	New	Total		
Borrower / TWR	0	TBA	TBA	TBA	
Borrower Unit/TWR-Group	0	TBA	TBA	TBA	

all amounts in EUR million

## 3. Application

Credit Type	Amount	Sec. acc. to Guidelines	Maturity	Purpose
1. CDS Line	2,250	2,052	2034	Cash collateralised CDS
2. Liquidity Facility	2,250		364 days	Standby Liquidity (NewCoSPV2)
2. Repo Line	45		364 days	Repo line (NewCoSPV3)
<b>Sum</b>	<b>2,295</b>			

**Collateral** MW BLW Terms

CLN referencing a portfolio of Real Estate Loans and secured by cash.

### Other details regarding the application

Implicit interest, currency and/or liquidity components of an option

Yes  No

Loan contract includes "syndication clause"

Yes  No

(see 5.1)

#### 4. Commitment Summary

all amounts in EUR million

##### a) Borrower/TWR HSH Nordbank AG incl. application

as per 02/11/2007

Credit Type	Prior Line	New Line	Sec. acc. to Guidelines	External lines	Outstanding
Credits up to 1 y (NewCoSPV2)	0	2,250		2,250	
(current accounts, loans) for 1 y and up to 5 yrs					
for more than 5 yrs					
Guarantees, Letters of Credit					
Trading Lines (NewCoSPV3)	0	45		45	
Trading Lines (NewCoSPV1)	0	2,250	2,052	198	
Individual decision trading activities					
General Credit Lines					
Participations					
Commitment Foreign Branches					
Sum prior to Syndication		4,545	2,052	2,493	
./. Share for Syndication					
Sum		4,545	2,052	2,493	

Settlement Lines

Guarantee Commitment  
Tenant/ Charterer Commitment

Amount  
Amount

##### b) Borrower Unit/TWR-Group HSH Nordbank-Group incl. application

as per 02/11/2007

Credit Type	Prior Line	New Line	Sec. acc. to Guidelines	External lines	Outstanding
Credits up to 1 y (NewCoSPV2)	0	2,250		2,250	
(current accounts, loans) for 1 y and up to 5 yrs					
for more than 5 yrs					
Guarantees, Letters of Credit					
Trading Lines (NewCoSPV3) - Repo	0	45		45	
Trading Lines (NewCoSPV1) - CDS	0	2,250	2,052	198	
Individual decision trading activities					
General Credit Lines					
Participations					
Commitment Foreign Branches					
Commitment Subsidiaries					
Sum prior to Syndication		4,545	2,052	2,493	
./. Share for Syndication					
Sum		4,545	2,052	2,493	

Settlement Lines

Guarantee Commitment  
Tenant/ Charterer Commitment

Amount  
Amount

##### Other information

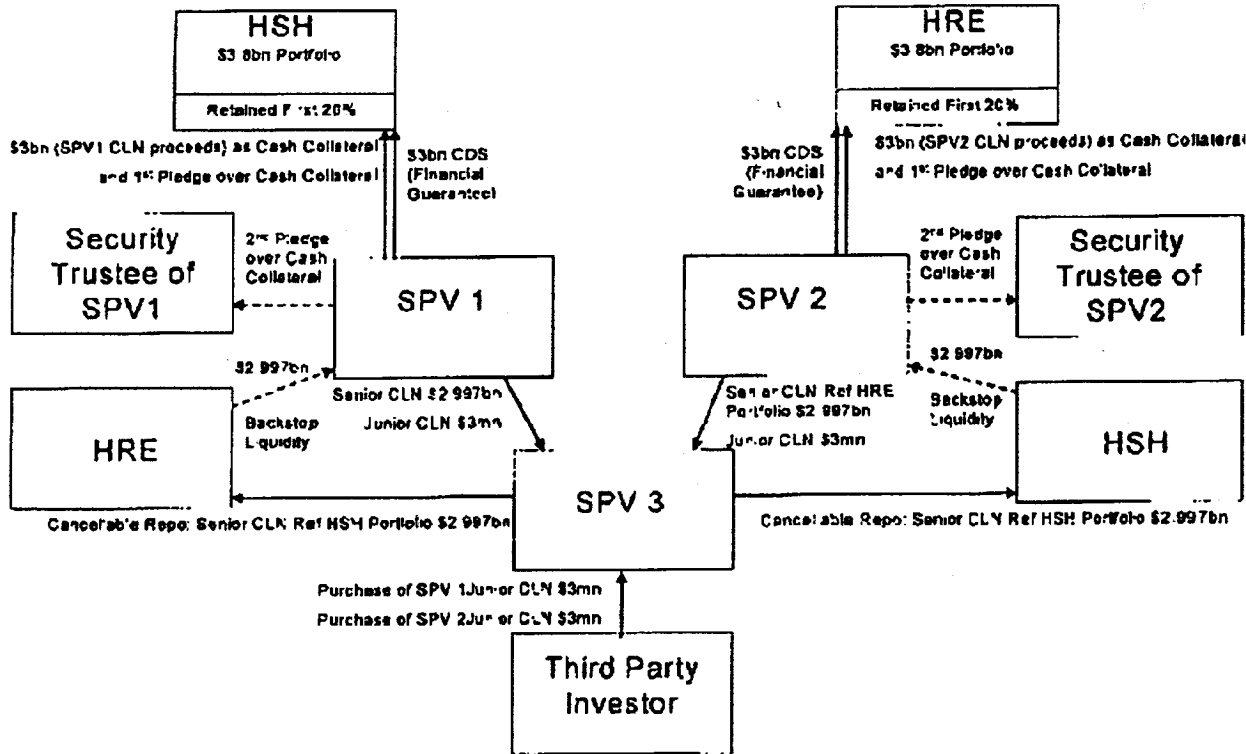
The Liquidity & CDS line requirement is USD3bn, which has been converted at 1.467 plus a 10% add on for currency fluctuations. The rating of the SPVs will be finalised as a result of the due diligence review and analysis of the HRE portfolio in conjunction with KRM. The rating will be based on the fact that they only holds assets that are either cash or have securities that have in built credit enhancement required for an approximate AAA rating.

## 5. Analysis

Global Head Book  
London

### 5.1 Notes on the application/ object/ project

Structured Credit Analysis in co-operation with BU Real Estate and Global markets has been working with Hypo Real Estate Bank International AG ("HRE") on a mutually beneficial structure to optimise both HSH's and HRE's Risk Weighted Asset ("RWA") exposure. Based on the result of this work, this credit application seeks approval for a solution that reduces RWA on a HSH portfolio of Real Estate assets of up to \$3.8bn (the "Portfolio"), whilst providing a segregated backstop liquidity facility to a new SPV, NewCoSPV2. Importantly this transaction has received approval from Legal and Compliance Department in Kiel that it meets the BaFin requirements for Basel I purposes and has also been reviewed by external legal counsel at Clifford Chance. The transaction can be represented as follows:



In order to reduce the current RWA of the Portfolio, HSH will purchase Credit Default Swap protection referencing the Portfolio (the "HSH CDS") from NewCoSPV1. The nominal value of the HSH CDS will be \$3bn (the "Protected Portfolio") and will therefore incorporate a retained first loss of approximately 20% (the "Unprotected Portfolio"). NewCoSPV1 will provide \$3bn cash to HSH to collateralise its exposure. As a result the Protected Portfolio will receive an RWA of 0%. NewCoSPV1 will finance the collateral via the issuance of a \$2.997bn Senior CLN (the "SPV1 SnrCLN") and a \$3mn Junior CLN (the "SPV1 JnrCLN").

Contemporaneously, with the above, HRE (rated A/A1/A\*+ by S&P/Moody's/Fitch respectively) will purchase \$3bn CDS protection (the "HRE CDS") from NewCoSPV2 which will be fully cash collateralised. The HRE CDS will reference a portfolio of \$3.8bn equivalent of real estate assets. Similarly, NewCoSPV2 will finance the collateral via the issuance of a \$2.997bn Senior CLN (the "SPV2 SnrCLN") and a \$3mn Junior CLN (the "SPV2 JnrCLN").

To finance the purchase of the CLNs, NewCoSPV1 and NewCoSPV2 will both enter into repurchase agreements with a separate entity, NewCoSPV3. In turn NewCoSPV3 will finance itself with separate repos with HSH and HRE the collateral for which will be the respective Senior CLNs. Importantly, HSH will not repo a CLN referencing assets originated by itself i.e. the SPV1 SnrCLN. Whilst both the Senior CLNs will not be rated due to the credit enhancement the implied ratings will be AAA.

An external 3<sup>rd</sup> party investor will purchase 100% of the equity of NewCoSPV3. NewCoSPV3 will purchase the equity of both NewCoSPV1 and NewCoSPV2 both of which will represent approximately 51% of the first loss.

HSH will provide a 364 day Backstop Liquidity Facility ("BLF") to support NewCoSPV2 in the event that the

repo facility with NewCoSPV3 is unavailable to provide funding. Again, whilst it is not envisaged to be drawn, to the extent that the BLF is actually drawn this will be secured by the SPV2 SnrCLN. HRE will provide a separate backstop liquidity facility to NewCoSPV1.

The actual assets that will form the Portfolio have not been finalised as yet. Therefore detailed analysis including the weighted average rating, spread, expected loss and economic capital requirement cannot be included in this application. In addition HRE have still to provide details on their likely portfolio, which will be subject to due diligence analysis by BU Real Estate. However, in view of the extremely tight timeframe for approval, documentation and execution, and the fact that this application requires Competence 1 level approval anyway, it is proposed that once the Portfolio has been finalised (and the aforementioned calculations made) this information be confirmed to KRM.

The transaction as considered above has been reviewed and approved as acceptable by NPNM (see attached NPNM vote). The daily mark to market of the Senior CLNs issued by SPV1 and SPV2 will be provided by HRE and HSH respectively. BU Real Estate will arrange for their credit analysts to ensure a suitable valuation is provided taking into account the loans the retained 20% and the first loss. This is a feature of the transaction.

## **5.2 Notes on the borrower / TWR**

NewCoSPV2 is to be a bankruptcy remote SPV to be incorporated in the Republic of Ireland or other suitable jurisdiction. NewCoSPV2 is a new SPV and will be set up to meet the usual SPV requirements i.e. bankruptcy remote, no employees etc. The appropriateness of the legal documentation will be reviewed and verified by HSH legal counsel before any transaction with NewCoSPV2 is executed. NewCoSPV2 will not be explicitly rated.

NewCoSPV1 is to be a bankruptcy remote SPV to be incorporated in the Republic of Ireland or other suitable jurisdiction again meeting the usual SPV requirements. NewCoSPV1 will not be explicitly rated. Despite the fact that HSH will not be transacting directly with NewCoSPV1, the appropriateness of the legal documentation will be reviewed and verified by HSH legal counsel.

Finally, NewCoSPV3 is to be a bankruptcy remote SPV to be incorporated in the Republic of Ireland or other suitable jurisdiction meeting standard SPV requirements. NewCoSPV3 will not be explicitly rated. The appropriateness of the legal documentation will be reviewed and verified by HSH legal counsel before any transaction with NewCoSPV3 is executed.

## **5.3 Legal Situation**

The transactions that NewCoSPV2 and NewCoSPV3 executes with HSH will be legally ring-fenced and also bankruptcy remote. HSH internal and or external legal counsel will review all documentation. In addition Legal Department in Kiel have reviewed the structure and confirmed that the Basel I RWA treatment described within this application is appropriate.

## **5.4 Industrial Sector / Market / Evaluation Portfolio Management**

The financing of NewCoSPV2 is to be in the form of repo lines from NewCoSPV3. As the repo is to be fully funded at inception, minimal risk is foreseen for this element of the transaction. It is expected that NewCoSPV2 and therefore NewCoSPV3 will be financed by repo throughout the duration of the transaction.

The HSH CDS and the HRE CDS will be purchased to match the maturity profile of the underlying respective real estate portfolios. In turn the CLNs will also be issued to the same maturity. It is proposed that the actual repo transactions will be structured to roll on the same day on a monthly basis. Whilst the Senior CLNs are funded via the repo facility the default risk will be assumed by the relevant repo counterparty after the equity position which is ultimately assumed by the third party investor. The documentation of the repos will be such that 100% of the financing of NewCoSPV3's CLNs must be via the repos with HSH and HRE simultaneously. In the event that the HSH and HRE repos cannot be rolled then NewCoSPV3 will not roll the repos with NewCoSPV1 and NewCoSPV2 which will ultimately trigger a funding requirement under the HRE liquidity facility and the BLF.

HSH will retain the right to terminate the repo with NewCoSPV3 if it determines that the price of the repo has exceeded the market level appropriate for the underlying SPV2 SnrCLN. HRE will have the same right with respect to its repo.

HSH's ultimate recourse will be to the assets of NewCoSPV2, being the SPV2 SnrCLN and the cash collateral. Whilst we are still awaiting the exact details of the HRE portfolio to be included in this transaction it is understood that it will be largely European based commercial real estate. In view of the short time available it is proposed that this application is on the basis that approval is subject to a satisfactory due diligence of the portfolio by BU Real Estate Department analysts plus KRM. As the HRE portfolio is likely to be denominated largely in Euro, HRE will assume the cross currency risk with NewCoSPV2. HSH is protected as the SPV2 SnrCLN and the cash collateral will be in USD.

In addition to the detailed review of the HRE portfolio, NewCoSPV2 and NewCoSPV3, and therefore HSH via the repo and possibly the BLF, will benefit from the credit enhancement provided by HRE. Over and above rating agency methodology it is proposed that the credit enhancement is sized at approximately 20% thus ensuring a AAA risk profile. For the avoidance of doubt neither the Senior CLN's will be rated and therefore the AAA rating is implied only.

In order to mitigate against the risk of a default of HRE creating losses for NewCoSPV2, NewCoSPV3 or potentially HSH via the repo or BLF, Clifford Chance have advised that protection against this is afforded under German law. Immediately prior to a HRE bankruptcy HRE's CDS contract with NewCoSPV2 would be cancelled and the cash collateral returned. At this point it is highly likely that HSH would too choose to unwind it's protection from NewCoSPV1.

Notwithstanding the legal assessment and whilst of course HSH provides both the BLF and the repo to NewCoSPV1 and NewCoSPV3 respectively, given the restricted nature of transactions that the SPVs will conduct it is reasonable to assume that HSH has a degree of indirect exposure to HRE via this transaction as contemplated and vice versa. A separate application for limits on HRE is therefore being prepared. As a mitigant against potential long dated counterparty exposure the transaction it is proposed that the HSH and HRE will retain regulatory call features at the option.

### 5.5 Economic Situation

The main driver for the transactions contemplated is to optimise HSH's Basel I capital charge. As a result of executing the transactions HSH stands to make significant Basel I capital savings as follows:

Description	Risk Weight	Capital Ratio	Basel I Capital
Existing \$3.8bn Portfolio as currently booked	100 <sup>1</sup> %	8%	\$304,000,000
\$3bn Protected Portfolio	0%	8%	\$0
\$0.8bn Unprotected Portfolio (less 1 <sup>st</sup> loss)	100%	8%	\$61,600,000
First Loss of Unprotected Portfolio	100% * 3	100%	\$7,100,00
NewCoSPV2 Liquidity Facility	0%	8%	\$0
NewCoSPV3 \$3bn Repo Facility	100%	See below	\$0 (minimal)
<b>Maximum Total Basel I Capital "Saving" to HSH</b>			<b>\$235,300,000</b>

Whilst the Portfolio remains to be finalised an initial draft provided by BU Real Estate has an expected loss of approximately 6.2 basis points. Based on this expected loss, the above table is consistent with Legal and Compliance Department's approach to the capital treatment of retained first loss pieces, such as that for the Unprotected Portfolio, which requires that 3 times the amount of the expected loss must be treated as a one for one deduction of capital. Any residual portion of the first loss that is outside of this calculation may be treated as a 100% RWA with an 8% capital ratio applied.

Reflecting the fact that the HSH CDS will be cash collateralised by NewCoSPV1, the Protected Portfolio will enjoy 0% RWA. In addition as the BLF will be structured as a 364 day contingent facility to be drawn in the event that the repo cannot be rolled and not against defaulted assets this too will enjoy a 0% RWA treatment.

The repos are to be booked onto the Global Markets Trading Book. In discussions with Group Risk Management as the repos are for less than one year the required line is calculated as the total nominal repo line times by 2% (i.e. 2,250,000 x 2% = €45mn equivalent). However, as advised by Group Risk Management, capital charges will only be incurred to the extent that the line is utilised. Utilisation will only be as a result of

<sup>1</sup> Please note that the portfolio is not certain at this point and that a lower average risk weight on the portfolio reduces the RWA savings.

mark to market movements in the underlying collateral, which in this case for HSH will be the SPV2 SnrCLN. As the SPV2 SnrCLN will benefit from the 20% credit enhancement and be referenced to a bespoke portfolio of HRE originated assets it is expected that the price will not significantly deviate from par. Assuming this is the case and the SPV2 SnrCLN does not experience negative credit events within the underlying reference portfolio, little to no capital charges are expected as a result of the repo line.

As discussed, Global Markets are working with various third party external investors to purchase 100% of the equity of NewCoSPV3 (the "Equity"). NewCoSPV3 will purchase the equity of NewCoSPV1 and NewCoSPV2. The sizing requirement of both these equity stakes will be calculated as at least 51% of the total expected loss of the underlying real estate portfolios. However, as both the HSH and HRE real estate portfolios are to be finalised the exact amount of the Equity is unclear but it is expected to be in the region of \$6mn. Terms have not as yet been agreed on the return that will be payable on the Equity but it is expected to be in the region of 30%. Whilst a high number as the actual nominal amount is small the cost is deemed acceptable in view of the RWA savings achieved.

Again, as the Portfolio remains to be finalised, the weighted average spread of the Portfolio is unknown but via the structure will continue to accrue and be payable for the benefit of HSH. The cost of purchasing the HSH CDS, which gives rise to the Protected Portfolio achieving a 0% RWA, will be less than the margin on the Portfolio. Whilst as not yet determined the premiums on the CDSs will be sufficient to pay the spread on the repo, the commitment on the BLF, the return on the Equity and the SPVs running costs.

## 5.6 Commitment Strategy

This transaction is consistent with HSH's desire to optimise its Basel I RWA within an efficient framework.

## 5.7 Other essential notes

It should be noted that whilst HSH does not take a direct exposure to HRE as both the BLF and repo facilities are provided to NewCoSPV2 and NewCoSPV3 respectively and it is the view of Clifford Chance that the cash collateral is not at risk due to a HRE bankruptcy, there is none the less a potential indirect exposure given the limited purpose nature of NewCoSPV2 and NewCoSPV3. Whilst technically no limit is required, KRM and Group Risk Management are being consulted as to the most prudent way in which this indirect exposure should be captured in HSH's systems. The approval of this application recognises that the indirect HRE exposure that HSH assumes is a crucial element of the transaction which may require, in due course, an appropriate line recorded against it.

Whilst HSH will purchase protection from NewCoSPV1 it is viewed that no lines are required for the vehicle due to the facts that i) the exposure will be fully cash collateralised and ii) it is intended that settlement for all parts of the structure will take place on a netted basis to the extent possible. However in the event that the latter is not possible then settlement lines might be required which again would be viewed as a pre-requisite of the transaction. However with the approval of this application any subsequent line required by NewCoSPV1 as contemplated herein is also considered to be approved.

## 5.8 Summary

### Opportunities/Strengths

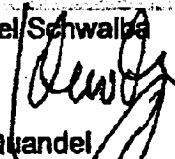
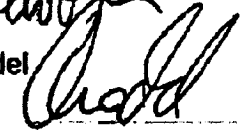
### Risks/Weaknesses

- |       |  |  |
|-------|--|--|
| 5.8.1 | - This transaction meets HSH requirements to optimise its RWA at minimal cost within an efficient framework.   | - Execution: Risk of HRE not completing the transaction as contemplated or in time.  |
| 5.8.2 | - The transaction has been initially approved by Legal & Compliance Department as BaFin compliant for Basel I purposes, subject to satisfactory final documentation. | - Mitigant: HRE is a respected counterparty which has an equally pressing requirement for RWA optimisation.<br>- Equity investor execution: Risk of the third party external investor not completing the transaction as contemplated or in time.   |
| 5.8.3 | - Respected co-arranger in HRE who have the same drivers as HSH.   | - Mitigant: Several existing clients have already been identified and expressed a strong interest. The Equity offers an attractive return for the small nominal risk assumed.<br>- Additional exposure: Via the repo and BLF HSH will be exposed to both real estate assets from HRE and potentially HRE itself.<br>- Mitigants: HSH will conduct a due diligence review of the HRE portfolio, which itself benefits from 20% credit |

**Conditions**

Approval is subject to:

- Satisfactory legal review of documentation;
- Satisfactory due diligence review of HRE real estate assets; and
- Completed analysis by BU Real Estate of Portfolio, including expected loss.

Originator	Name of Votour Market-BU	UB Real Estate	Global Heads
Steve Powell	Luis Marti Sanchez General Manager London Branch	Michael Schwalbe 	Paul Duffy / Frank Otten Head of Originations
Marc Schack		Lars Quandt 	
Structured Credit Analysis			